## **Intermediate Microeconomics**

# Chapter 1 Introduction

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## What is microeconomics?

- Economics = the study of how people and societies deal with scarcity
- Microeconomics = the branch of economics focusing on the economic behavior of individual decision-making units and how these individual decisions fit together

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# The three questions in (micro)economics

- 1. What to produce?
  - opportunity cost = what is given up in order to obtain something
- 2. How to produce it?
  - allocation of resources
- 3. Who gets the output?
  - centrally planned economies vs. market system

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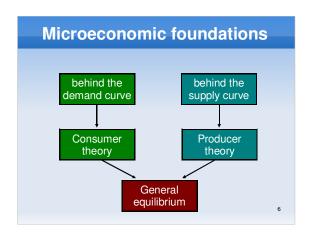
# **Economic analysis**

- Models = a simplified description of some aspect of the economy
  - used to answer specific questions based on some simplifying assumptions
- Two types of analysis/statements:
  - normative = descriptive statements (cause and effect)
  - positive = value judgments

## **Microeconomic foundations**

- How consumers choose what to consume
- How firms choose how much to produce
- How firms choose the amount of labor and capital to use
- How do these actions coincide to bring about a market outcome

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# Circular flow of the economy Product Markets Product Markets Firms Factor Markets Factor Markets

# Circular flow of the economy

- Markets regulate the flows between the two sectors
- Simplifying assumptions:
  - ignores within-sector transactions (firm-firm or household-household)
  - ignores government (provision of law, taxes, public goods, etc.)

# Supply and demand model

- What guarantees that the activities of the two sectors are coordinated?
- In a centrally planned economy, a central planner would try to adjust quantity produced and/or price so as to reach a consensus
- In a decentralized (market) economy, this is achieved by the interaction of supply and demand

### **Demand**

- Factors influencing demand:
  - tastes
  - price inversely related (law of demand)
  - income positively (normal good) or negatively (inferior good)
  - prices of related goods positively (complements) or negatively (substitutes)

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# Demand schedule vs. Quantity demanded

- Demand schedule = the relationship between market price and quantity demanded at a given time, all other things equal (ceteris paribus)
- · Changes in factors:
  - price movement along the curve
  - any other factor shift in the curve

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# **Supply**

- Factors influencing supply:
  - technology
  - price positively (law of supply)
  - price of inputs negatively

# Supply schedule vs. Quantity supplied

- Supply schedule = the relationship between market price and quantity supplied at a given time, all other things equal (ceteris paribus)
- Changes in factors:
  - price movement along the curve
  - any other factor shift in the curve

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# **Equilibrium**

- Equilibrium = a state that persists because nobody has any incentive to change their behavior
- In the supply and demand model, equilibrium is achieved when quantity supplied (Q<sup>s</sup>) = quantity demanded (Q<sup>d</sup>):
  - if  $Q^s > Q^d$  (excess supply), then price falls
  - if  $Q^s < Q^d$  (excess demand), then price rises

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# The market for inputs

- The supply and demand model can be applied to the market for inputs as well
- In this case:
  - · demand comes from firms
  - supply comes from households
  - price = wages, rents, etc.
- The equilibrium is coordinated by "prices"

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# The role of prices

- Prices have three major roles:
- (1) convey information signal changes in the market factors, inducing the corresponding changes in behavior
- (2) ration scarce resources more scarce resources cost more, hence quantity demanded is lower
- (3) determine incomes who gets what is produced

# **Part 1: Consumer theory**

- Preferences
- Utility functions
- Budget constraints
- Optimal choice
- Demand

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# Part 2: Producer theory

- Technology
- Production functions
- Cost curves
- Profit maximization
- Supply

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# Part 3: General equilibrium

- Pareto efficiency
- An exchange economy
- A production economy
- Production and consumption in general equilibrium
- The fundamental theorems of welfare economics

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# Part 4: Market failure

- Market power:
- monopoly
- monopolistic competition
- oligopoly
- strategic behavior among firms
- Missing markets:
- public goods
- externalities